RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

January 4, 1979 **LETTER 747**

Dec. 22, DJIA 808.46; PTI 858; A-D ratio –21.81
Dec. 29, DJIA 805.01; PTI 846; A-D ratio –22.20

FLOW: I spent the first 35 years of my life in New York City. I grew up in Manhattan, a fighter, a plugger, a survivalist, a self-pressurer and (thank God) a bit of a searcher. Somehow I sensed that I was doing almost everything wrong. Yet I could never experience just how I was "doing it" wrong, or to put it another way, how I was living my life wrong. What I discovered would fill three or four volumes, but that's another story.

In 1961 I moved to "Lotusland, USA," better known as California. And it was here that I began to better understand what I was doing to myself. Life here felt different to me. And it was different. It was slower, prettier, less intellectual (which is a minus), and certainly more relaxing. About three years ago I married Paula, a true California girl (brought up in Palm Springs), and slowly, very slowly, I began to see what I was doing to myself. I was fighting life, wrestling with my own life, other people's lives, fighting the markets, the country, the world. I was a clenched fist.

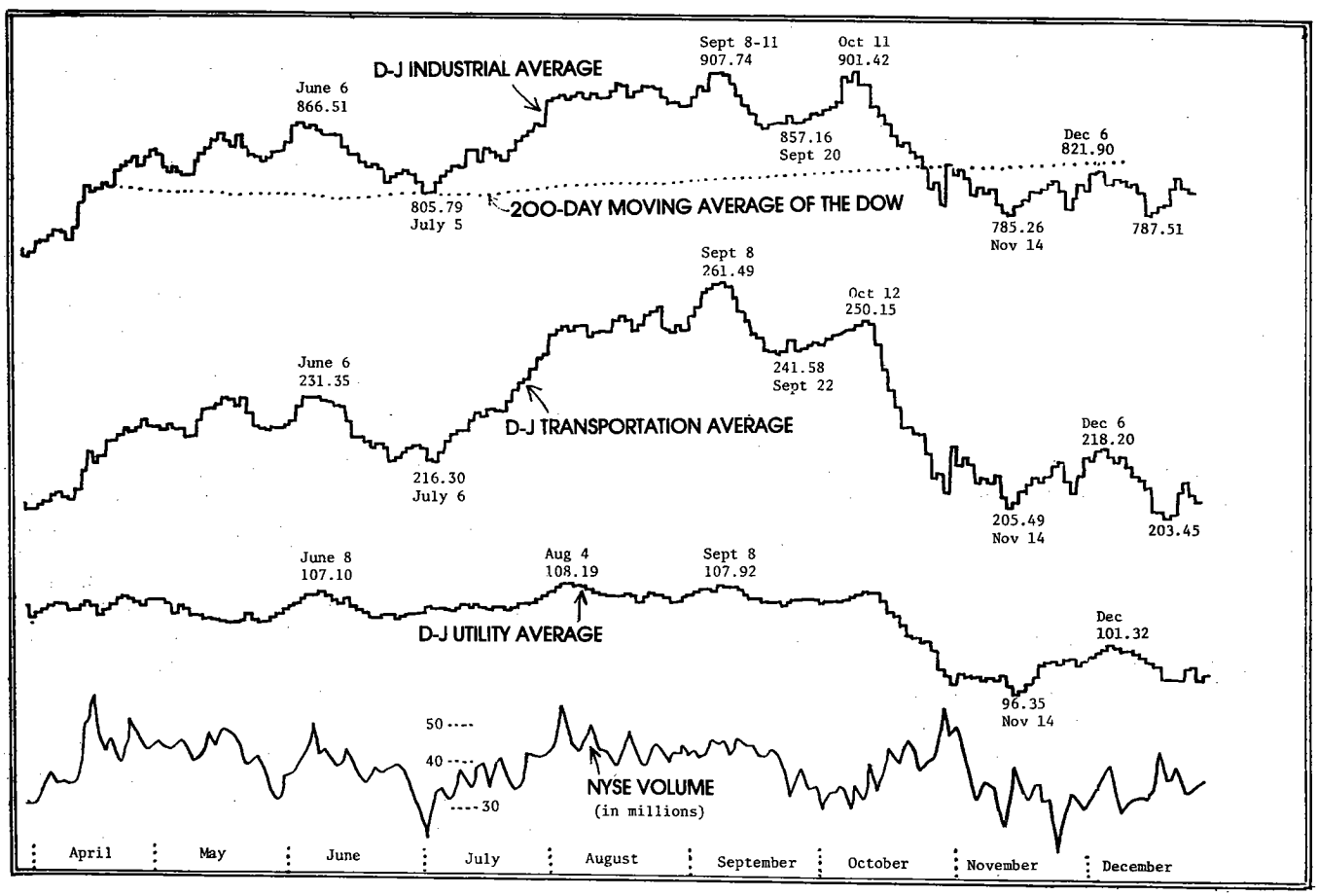
It took me three years with Paula (all the time observing her carefully and marveling) to understand the basic concept which I admire so much in her. The concept can best be summed up in the expression (her words), "go with the flow." To me (a "do something, do *anything*" New Yorker) the idea of going with the flow came as a revelation. I had always tried to use that principle in my market work, but somehow I had never really zero'd in on exactly how that same principle might apply to my life.

So for those who are not involved with a serene California girl, I want to go into the "flow" idea further. I found myself setting up strict patterns in absolutely everything. I "had to" get up at 4:30 AM, I had to jog at 5 AM, I had to get all the market figures by 2 PM, I had to do everything"by the numbers." All this amounted to unending pressure. But I have always felt *safe* with pressure. Patterns and pressure had become the "safe" keys to my life.

To make a long story short, I am now in the process of de-programming myself, and it may be the best thing I ever do. But lest you misunderstand, the important thing in everyone's life is to get centered, to find the sane middle.

I'm not saying that "no pressure at all" is good, and I'm not saying that some patterns and programs aren't good. In fact, I often wish they could send half the kids in California to New York so they could see what struggle is, and I often wish they could send half of New York's kids to California so they could experience the free, happy "laid-back" life.

At any rate, what I've concluded is that God's world flows like a river. And it's our job to experience the flow, to get in harmony



New Government Issues' Record Returns Attract a Horde of Individual Investors

By PHIL HAWKINS
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK–Record interest returns became available on the array of new government issues being offered this week, a clear sign of the credit market's deteriorating condition, dealers said.

Those rates, highest at least since the Civil War, lured a mob of individual investors. For example, about 1,000 persons showed up at the New York Federal Reserve Bank to place orders for portions of the $2.5 billion each of two-year notes and four-year notes being sold by the Treasury.

That turnout was "heavier than usual," a spokesman for the bank said. It was especially so considering that many investors have become accustomed to ordering Treasury securities through the mail rather than in person and also that, unlike in previous periods of peak rates, they have alternative high-yielding investments such as the six-month savings certificates.

Rates have been rising for several months. However, they began to climb precipitously just last Monday when serious in-

A prime rate rise to 11¾% from 11½%, initiated last week by Chemical Bank, was posted by many major banks in response to continued credit tightening by the Fed. At the same time, rates in the federal funds market leaped; some hit as high as 15%.

Treasury Auction Of 2-Year Notes Sets Record 9.99% Yield

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON–The Treasury's sale of $2.51 billion of two-year notes brought an average return of 9.99%, the highest for any Treasury note or bond since at least the Civil War.

The 9.99% return eclipsed the record 9.36% average yield set at the previous two-year note auction Nov. 21.

At the latest sale, the Treasury received $5.32 billion in tenders for the notes and accepted bids at yields ranging from 9.97% to 10%, including $655 million in noncompetitive tenders at the average return. The agency accepted 54% of the tenders at the highest yield.

The coupon equivalent rate was 9¾%, also a record, up from 9¼% at the Nov. 21 auction.

Savings Banks Show Outflow For November

First in Over 30 Years Totals $125 Million Net

NEW YORK (DJ) – The nation's mutual savings banks experienced a $125 million net deposit outflow in November, according to preliminary figures released by the National Association of Mutual Savings Banks.

"This is the first time savings banks have experienced an outflow in the month of November since the association began compiling industry deposit statistics in 1947," Saul B. Klaman, president of the association said.

* * *

Fannie Mae's sale of four-month commitments to buy home loans brought yields that were the highest on record.

I guess you might call this first mailing of 1979 the "money issue," because I obviously emphasize money and interest rates throughout these pages. I do that for a purpose–I believe the KEY to 1979's markets is going to be spiraling interest rates and the insatiable demand for money. And a rising level of interest rates constitutes a situation which is almost impossible for the stock market, the bond market and the commodity market to adjust to. Prognosis–erratic, wild, emotional markets.

In order to dramatize the picture, I am including a few news clips from various financial papers, all gathered within the last few weeks. This is where the big story of 1979 is being told–and what you see here is only the beginning.

with that flow, and then do what has to be done along the way. Each of us is responsible for getting ourselves in harmony with this mighty (but often very subtle) flow of the universe. Once we do that, the (self-inflicted) pressure subsides, the sun comes out, the hurricane winds die down, and life begins to take on meaning and wisdom.

So much for me and the flow. What I want to do now is demonstrate that this same concept *applies exactly* to the world of investments. For there is a flow in the markets as surely as there is a flow in the Hudson River or the Colorado or the Mississippi. In the last Letter I showed how the main mass of the market (as represented by the S&P 500 Composite) hit it's highs during 1976. Since then the market has run up, run down, popped, crackled and crunched, but essentially gone nowhere. My guess is that three out of every four traders have made little or nothing for all their sweat since mid-1976.

What has happened? Basically, the main upward flow stopped for stocks during mid-1976. But around that time another upward flow commenced. The new flow was the **steady rise in interest rates**. By mid-1977 the advance in interest rates was becoming obvious to all, By early 1978 the interest rate rise was becoming dramatic. And by late-1978 the tide of rising interest rates was a major, if not THE major force on Wall Street.

My own feeling (intuition) tells me that 1979 is going to see interest rates dominate the entire financial scene. Sensing this many months ago, I urged all subscribers to move into the one vehicle that will "go" with the interest rate flow. That vehicle is short-term paper, and the kind of short-term paper I prefer is the Treasury bill. Those who are invested in (and "rolling over") T-bills have been collecting a steadily rising return since last year, and they have not had a bad moment doing it. At present, the return (no state taxes) is 9.3% on T-bills, and every indication suggests that interest rates are heading substantially higher.

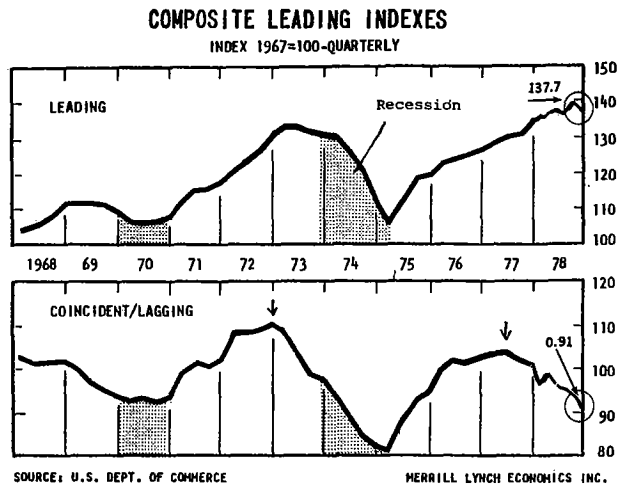
I've said this before, but let me repeat it for new subscribers. The dollar is going to be KING for a number of months ahead, and one of the reasons is that the high level of interest paid on dollars will prove to be IRRESISTABLE. When short to medium-term money goes "double digit," the pressure is on, and that's about where we are now. Oh, you can scalp the market here, you can jump into a gold rally, you can be lucky enough to have bought IBM just before the split, you could have shorted live hogs two weeks ago before the break, but in general you will be better off just being invested WITH THE FLOW. And the flow is now to rising interest rates. Thus, the "peaceful and harmonious" place to be in the investment world today is with those boring T-bills that pay 9.3%.

No one knows how long the interest rate rise is going to continue. The consensus talk, the economic "buzz phrase" for 1979 is that there will be "a mild recession starting in late 1979." Such a consensus calls for contrary opinions, and as I see it, the contrary opinions are (1) there will be no recession at all in 1979, the recession will start in 1980; or (2) it won't be a "mild recession in 1979," it will be the beginning of a depression, and it will start earlier rather than later in '79.

Contrary opinion no. 1 is certainly possible, but if it comes to pass (i.e., no recession in '79) then I would expect interest rates to go sky-high under the pressures of increasing demand for money, persistent consumer buying and steady capital expenditures.

Contrary opinion no. 2 (i.e., a gathering depression starting early in 1979) may sound far-fetched, but ponder this: (1) the stock market topped out three months ago, (b) the commodity index hit its high in November, (c) the index of leading indices turned down in November (see chart), and most interesting, the tell-tale ratio of coincident to lagging indices peaked in March, 1977, and has been declining ever since. This ratio turned down on average 16 months before the last four recessions. It has now been declining for the past 20 months!

If we have no recession in '79 then I would expect the trend of interest rates to go up and up, and in that case our current position in T-bills would be the correct one. If we have a developing recession-depression in '79, then the stock market will sense it and crash. In that case, we would still have been correct to be



in T-bills, but this would also entail a switch out of T-bills and into longer-term bonds before long.

OR–and I blush to even bring this one up, we could have the worst of both worlds on a milder scale. We could have rising interest rates, an economy that staggers on with plenty of problems, but an economy that does not want to cave in. In that case, 1979 would be a very frustrating place for stockholders (many whipsaws and intermediate rallies and declines but no real profits). And the best and safest place to be would still be money instruments and basically T-bills.

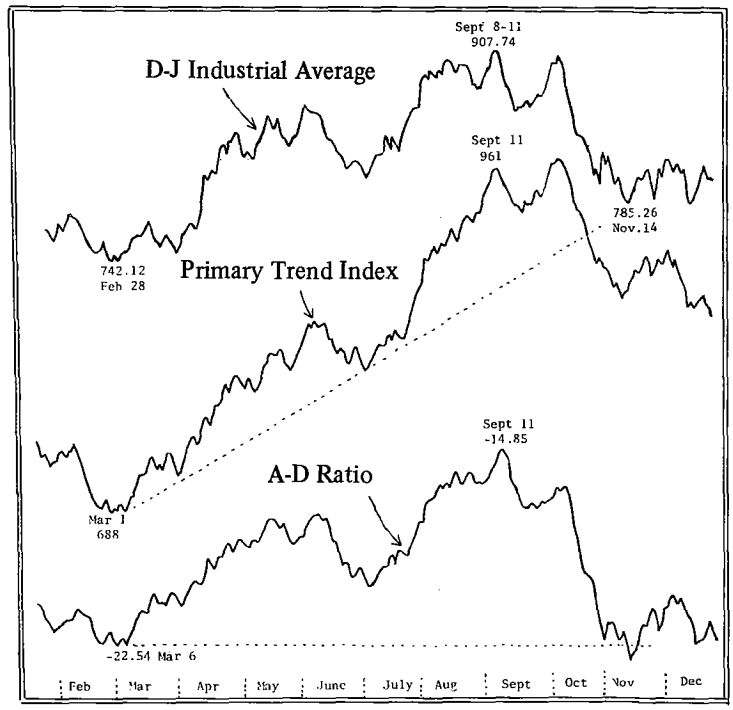
What's my own guess as to what lies ahead in '79? My guess is that somewhere along the line the stock market is going to take a major dive (starting before the end of the first quarter), and that by mid-year (July or before) the market could be in shambles. The falling stock market will frighten the public (a public which is heavily margined in both securities and in their personal affairs), and the frightened public will pull in their buying and topple the economy. It could all happen very fast, but the plus in this scenario is that we will see the first major oversold condition in the stock market since late-1974.

But remember, this is only a Russell scenario, not "the truth," and until we actually know what's happening it would be best to stay with the flow of rising interest rates. In the meantime, my instinct tells me that the markets are going to be doing everything they can to make us think that T-bills are the "wrong place" to be–but that's the way markets are. They entice us, they seduce us, they beckon us and then they pull the rug out from under us. Right now the river is running to higher interest rates, and that's where I personally am staying. And that's where I advise my subscribers to stay too.

CURRENT MARKET: For 8 weeks the Industrial Average has fluctuated within a range of 821.90 on the upside (see page 1 chart) and 785.26 on the downside. Within that narrow range of 36 points, a lot of money has been lost and very little has been made. During the same period the Transports have fluctuated within a range of 218.20 on the upside and 203.45 on the downside. Finally, the Utilities have been moving within a 5 point range of 101.21 on the upside, 96.35 on the downside.

As a rule, the longer the Averages hold within a narrow range, the more important the eventual breakout. So from the standpoint of Dow's Theory, a penetration by BOTH Averages above the December highs will definitely point the secondary trend to the bull side. Conversely, a joint breaking of the October lows will signal a continuation of the bear market.

In stand-off situations such as this one, the first significant movement by the Utility Average has often led the way for the rest of the market. Thus, it would pay us to watch the bellwether Utilities closely–101.21 on the upside or 96.35 on the downside.



The breadth of the market has been soggy ever since the September 11 peak, and in November (see chart) the advance-decline ratio actually broke to a new 1978 low. This low was not confirmed by the Industrials, an event that would ordinarily be expected to set off a good rally. The 36 point Dow rally since the November 14 low hardly fits the description of "a good rally," but in the face of rocketing interest rates, the Egypt-Israel mess and the disaster in Iran, who is to say that the market has not acted bravely in the face of bad news.

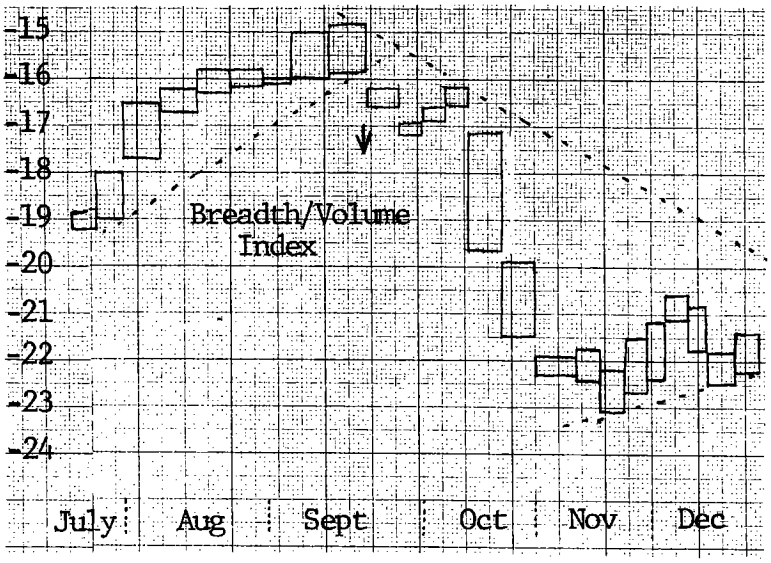
My Primary Trend Index (PTI), which is an amalgam of eight critical averages and indices, has acted worse than either the Dow or the A-D ratio. The PTI has broken decisively below its November low, an action that I take as definitely bearish. Note that all during February to October, the PTI was the strongest item on the chart, reacting least and advancing most on every swing. Now that situation has changed and the PTI is leading the way down.

In the 7 years that I have been keeping statistics on the PTI, I have never seen the market resist a **persistent** trend in the PTI. Therefore, if the PTI continues its trend to lower levels, I would say that the odds heavily favor the rest of the market following.

Two more comments: NYSE daily new lows have outnumbered daily new highs steadily without a single day's exception since October 17. That constitutes steady selling pressure in my book, and unless this situation is reversed it will lead to a big break in the market.

I commented in the last Letter on the current craze for "market timing." I also stated that it was very difficult for me to see any "contrary opinion" position in this market, because almost every scenario from boom to crash was being advanced in an

effort to be *contrary*. It has occured to me that a good contrary stance would be to **avoid market timing**, altogether, at least for a while. I think a full position in Treasury bills fills that ticket. Let the geniuses try to beat the market as double-digit interest rates grip Wall Street. I'll just stand aside with T-bills.



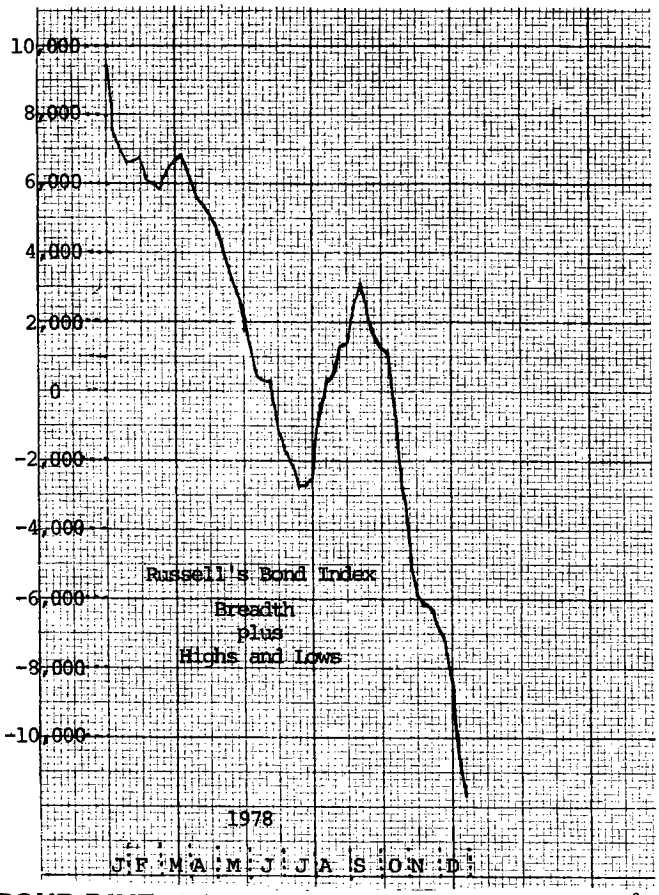
BREADTH-VOLUME: It isn't often that anyone comes up with a new and worthwhile technique in technical analysis of stock trends. I try one or two new theories or techniques on the average of once a month, and I throw out most of them as not worth the time and effort.

But a few years ago Richard Arms, Jr. wrote a book entitled "Profits in Volume" and in this book Arms introduced a technique of combining movement with volume. I used this technique on a number of different averages and individual stocks, and the area where I found it particularly useful was in the advance-decline figures on the NYSE.

I have included Arms' technique for the NYSE A-D ratio over the last six months, and it is most interesting. What we see here is a series of boxes. The top of each box represents the high day (for each week) on the A-D ratio and the bottom of the box represents the low day for each week. Horizontally, each box on the chart represents 25 million shares of NYSE volume, and the width of each box represents NYSE volume for the week. So if a rectangle on the chart is five boxes wide, it means that there were 125 million shares traded that week.

The weekly statistics as you see them on this chart give us a three-dimensional picture of what has been occurring over the last six months in breadth and volume. And frankly, I find the chart both fascinating and helpful. This technique also lends itself to trendline analysis, and the results of the boxes holding or breaking the trendlines appear to be most significant. One can also get a good feeling for areas of accumulation and distribution with the Arms technique. For instance, note the concentration of breadth and volume during August and early September. When this whole area was violated in October and early November the market went into an almost historic mini-crash.

During late October through December the breadth-volume boxes again formed a tight concentration or cluster of boxes, fluctuating within only 2½ points on the chart. It is obvious that a breakout of this tight "congestion area" will point the next important direction for the market. The long bearish trendline from the September peak suggests that this direction could be down.

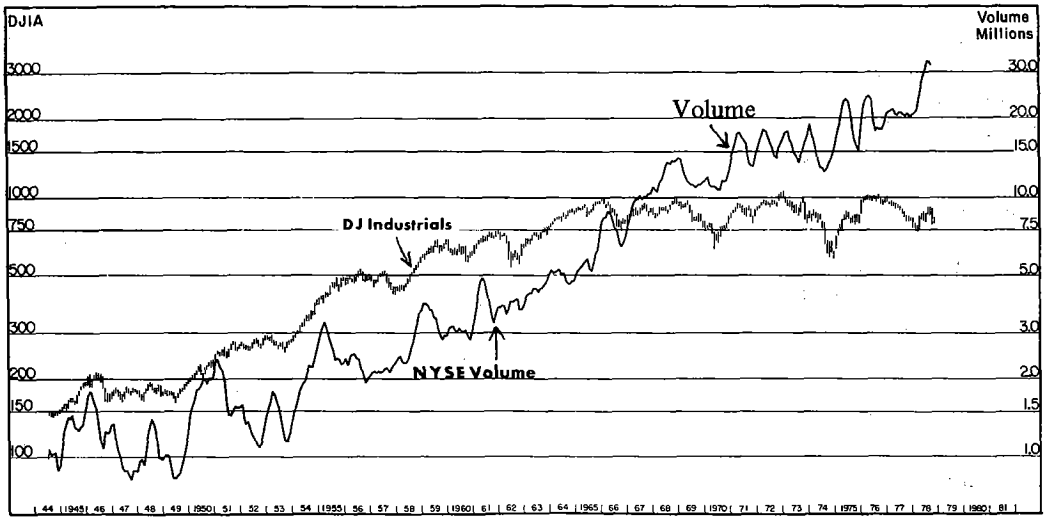


BOND DIVE: A few years ago I started working on indicators which would show the broad trend of the bond market. After numerous experiments, I decided that the best measure might be some type of **unweighted bond average** with the added "kicker" of incorporating the daily new highs and daily new lows. For this I used the NYSE bond transactions on a daily basis (with the daily figures computed once a week).

Each day roughly 800 to 900 bonds are traded on the NYSE. The statistics for the advances and declines and new highs and lows are available. So at the end of each week I add up all the advances and new highs and substract all the declines and new lows. Then I take this running total and chart it, and the results for 1978 can be seen here.

Clearly we are looking at a collapsing bond market, a bond market which produced only one significant rally during the year. This decline has wiped out billions of dollars in bond values, and there are few pension funds and institutions that haven't been hurt by the fury of this major bear market in bonds.

As I've said so many times before, there is no worse background for the stock market than a bond market that is sinking into quicksand. The reason is obvious–informed investors never say think in terms of the expression, "stocks are cheap." They think in terms of "stocks are cheap in terms of what?" And that "what" is almost always bonds. At present, with two-year Government notes yielding 10%, with some of the closed-end bond funds yielding near 11%, with average municipal bond yields (tax free) at 7.3%, stocks are not cheap, they are (at least in the minds of many value-conscious investors) rather expensive.



SUPPLY, SUPPLY: Mansfield Chart Service put out a most interesting study on November 20. They ran a monthly chart of the Dow (see chart, p. 5) along with a five month moving average of NYSE volume. The chart goes back to 1944, which gives us a long history.

Normally, volume will increase during a bull move, then drop off somewhat before the peak in prices. And this is exactly what happened during each major rise starting in 1942. In 1966 the Dow recorded a peak of 995.15, and that high has never been substantially bettered. But note that volume has steadily increased despite the 12 year stall-out in the Dow.

This increasing volume, unconfirmed by price, is a total departure of the price volume sequence which characterized the "normal" period of 1942 to 1966. What has happened?

The clear inference is that as time passed after the 1966 top in the Dow, more and more stock was offered for sale, and this accounts for the steady increase in volume. In other words, the long-term supply of stocks overtook demand around 1966, and since then (if we judge by the declining trend in the unweighted averages) any stepped up buying is quickly met with a new supply of stock. This shows up on the chart as "churning" with volume going to new highs while stocks move sideways within a trading range.

In my opinion, somewhere ahead we are going to see the trend of volume reverse to the downside. Note on the chart that the extreme lows of volume were recorded during 1947 to 1949. You can draw a trendline connecting the 1953 low and the 1974 volume low. This rising trendline traces a 29 year trend of rising volume. Eventually volume is going to simmer down and plunge below this trendline. When that happens, I would guess that the long, tedious bear market which began in 1966 will be about over.

NOTES: The second attack on the dollar in three months is upon us. One reason (or rumor) is that the Saudis failed to take a stand against the big oil price boost, and therefore the US is losing clout with the biggest Arab oil producer.

But just as important is the continued pussyfooting of the Fed on its monetary policy. As I have said many times before, the Administration and the Fed have an almost psychopathic fear of recession, and they'll do "anything to halt inflation" *as long as it doesn't bring on recession.* Unfortunately, that phoney game is not going to work much longer. We're at the place and the time where only a very hard, restrictive monetary policy will put a damper on inflation. If Washington now fails to put the clamps on the money supply, we will see the real trouble begin. The trouble, in fact, is already in motion as seen in the latest rally in the hard currencies and in gold.

My bet is that the Fed will continue to try to hold back inflation with interest rates. For that reason I expect another boost in the discount rate coming up soon. Watch for it, a ¼% boost would be nothing, a ½% boost would be barely acceptable, a 3/4% boost would be all right, and a 1% boost would show that the Fed meant business. But the world is convinced that Carter and Miller will accept inflation rather than a squeeze on the economy. In my opinion, the Administration's freedom to "continue playing games" is about over. From here on, the fat is on the fire!

* *

One of the most fascinating mysteries of the current situation is the toppy appearance of so many commodities. No area is more sensitive to inflation than commodities. Yet item after item has topped out, corn and coffee in June, Cotton, hogs, oats, wheat, O.J., pork bellies, the bean complex in October. Only lumber and possibly cattle still look bullish, and the metals at best look doubtful. Of course, everything could suddenly turn around and rush to new highs–they could, but they haven't so far. And I wonder–what are commodities telling us in the face of the almost unanimous inflation forecasts. A lot of traders, it would seem, are doubtful. And they've never been known for their stupidity!

* *

Apologists advance all kinds of reasons for the rotten US balance-of-payments, but the following is a contrast that the Administration doesn't want to talk about–namely the fantastic Japanese work ethic (contrast this with the new American "consumption ethic").

WORKAHOLICS The Japanese government has launched a campaign to persuade workers to take their annual paid holidays.

A majority of Japanese workers take less than one-third of the time off they are entitled to. They believe that utilization of full holiday time will reflect disloyalty or lack of interest in their work. Their allegiance to their employers is traditional and frequently fanatical.

It has gotten so bad that the Japanese ministry of labor is now distributing a series of illustrated leaflets encouraging workers to take advantage of their full vacation benefits. They explain that all work and no play makes for a too stressful life.

Some progressive firms, unable to convince their employees to go on vacation, have shut down factories for a week or two.

* *

The current (Jan. 1) issue of Barron's features their annual panel of experts with the usual array of opinions. It was all very interesting, and I only have two comments. Jay Levy has a remarkably good record, and he's been right for a long time. It always worries me when a man in this business is right for "a long time," because I suspect he's moving closer and closer to being wrong. Levy sees the odds as 2 to 1 against a recession in '79. 'Nuff said.

Seth Glickenhaus has to be one of the smartest and most successful bond traders in the nation . I spoke to Seth two weeks ago, and what he said to me then jibes with what he said on the panel. He does not like the interest rate picture (which I think most of the rest of the panel underestimates), nor does Seth like the fact that consumers are loaded with debt. Glickenhaus isn't trying to pinpoint the timing but he says that we may have a shallow recession at first, but "it's very possible that the recession will be deeper than anybody wants. Higher interest rates have a big impact. Some words are unmentionable these days.....Yes, it's unthinkable, but we may be facing a depression." (This writer has a lot of respect for Seth Glickenhaus and his judgments).

GOLD: I have expressed the opinion that gold is building a top. My suggestion was to lighten up considerably on the "B" leg or the first (upward) correcting leg of what I considered a potential "head-and-shoulders" pattern. But over the past few weeks the Iran situation exploded, and this followed on the heels of the whopping OPEC increase in the price of oil. Both of these "unexpected" news events were obviously bullish for gold, and in my opinion they pushed the B leg further than it would ordinarily have gone.

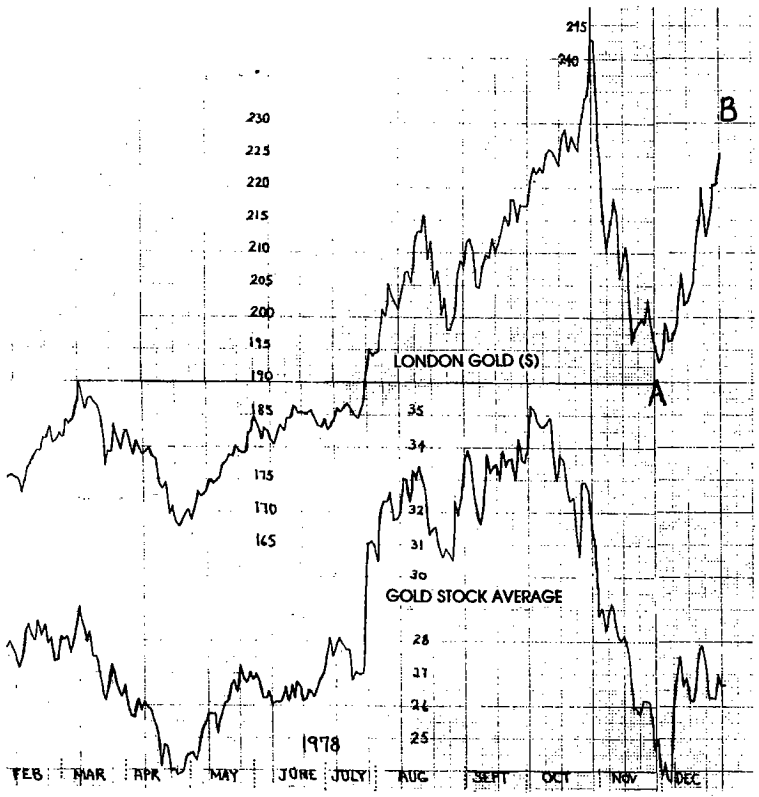
At this point, I believe gold is very over-bought and in extended territory, and I would expect the metal to turn down at any time. The wonder to me, in fact, is that the oil increase and the Iranian situation did not propel gold to a new high. If the *trend* was truly bullish for gold, I feel that recent news events would have seen gold already rising above its 243 peak of October, 1978.

The daily chart (at right) of gold and my gold stock average (GSA) is striking from one standpoint: on the latest advance GSA went absolutely dead in the 26-28 zone and it persistently refused to confirm the advance in gold. Compare the action of GSA during December with its action during the earlier April to October rise. Could the outlook for gold stocks have changed that much in a few months? I doubt it, and I see the reluctance of GSA to confirm bullion as a dangerous *non-confirmation.*

As far as the S.African gold shares are concerned, aside from political and racial problems, costs are rocketing. Tony Henfrey (PO Box 1078, Pinetown 3600, S.Africa, and he publishes a fine gold advisory) reports the following typical cost increases for the year ending Sept. 1978: Bracken up 14.9%, Kinross 21.1%, Leslie 9.9%, St. Helena 37.4%, Winkelhaad 22.4%. Even so, that still does not explain why the gold shares rallied sharply April to October and have gone dead on the latest rally (even the Canadians have died).

The 2X6 point and figure chart is very interesting here, and gold as seen on this chart, has now traced out a rather rare "diamond" effect. The first major upside resistance comes in at 230, the second at the high at 242. At 212 on this chart gold turns bearish again, so the chart provides us with three important points to watch.

LATE NOTES: I've said this before, but I want to repeat it: I believe investors have lost more money trying to beat inflation than they have made because of inflation. High interest rates are a function of high rates of inflation. Thus, if we have 10% inflation at this time, gold will have to go to 250 in order for the gold holder to break even (vs. bonds). Double digit interest rates (in a rising interest rate market) are *poisonous* to all forms of investments–except short term paper. That's what I want subscribers to understand as we move into 1979.



The stock market obviously senses the "double-digit interest rate" dilemma. And it knows it's moving slowly and relentlessly into the zone of the big squeeze.

NEXT MAILING: January 17th